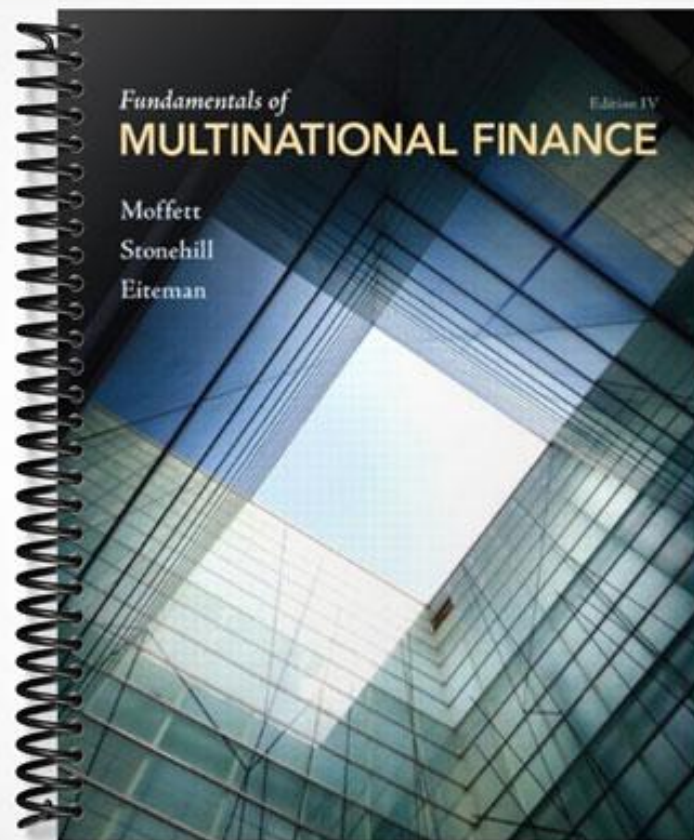


# SOLUTIONS MANUAL



# Chapter 2

## Financial Goals and Corporate Governance

### ■ Questions

1. **Ownership of the Business.** How does ownership alter the goals and governance of a business?

In a sole-proprietorship, the goals of the firm are perfectly aligned with management's goals since the owner is the manager. Governance is not an issue in a sole proprietorship. As the number of owners grows, the goals of the owners and managers of the firm will often diverge. In a large corporation, management typically owns a very small percentage of the total firm, yet management controls all of the day-to-day activities. Management's primary concern may be their own financial well-being, with the goals of the firm secondary. The numerous shareholders (owners of the firm) are not involved in the management of the firm are primarily concerned with the financial performance of the firm. The goals of the shareholders/owners are no longer aligned with the goals of management. This is where corporate governance becomes relevant. Good corporate governance practices should focus on the objective of maximizing shareholder wealth, which ensures corporate growth and improvement in the value of the corporation's equity.

2. **Separation of Ownership and Management.** Why is this separation so critical to the understanding of how businesses are structured and led?

The field of *agency theory* is the study of how shareholders can motivate management to accept the prescriptions of the shareholder wealth maximization (SWM) model. For example, liberal use of stock options should encourage management to think like shareholders. Whether these inducements succeed is open to debate. However, if management deviates too much from SWM objectives of working to maximize the returns to the shareholders—the board of directors should replace them. In cases where the board is too weak or ingrown to take this action, the discipline of the equity markets could do it through a takeover. This discipline is made possible by the one-share-one-vote rule that exists in most Anglo-American markets.

3. **Corporate Goals: Shareholder Wealth Maximization.** Explain the assumptions and objectives of the shareholder wealth maximization model.

The Anglo-American markets are characterized by a philosophy that a firm's objective should be to *maximize shareholder wealth*. Anglo-American is defined to mean the United States, United Kingdom, Canada, Australia, and New Zealand. This theory assumes that the firm should strive to maximize the return to shareholders—those individuals owning equity shares in the firm, as measured by the sum of capital gains and dividends, for a given level of risk. This in turn implies that management should always attempt to minimize the risk to shareholders for a given rate of return.

The SWM model assumes as a universal truth that the stock market is efficient. This means that the share price is always correct because it captures all the expectations of return and risk as perceived by investors. It quickly incorporates new information into the share price. Share prices, in turn, are deemed the best allocators of capital in the macro economy.

4. **Corporate Goals: Stakeholder Wealth Maximization.** Explain the assumptions and objectives of the stakeholder wealth maximization model.

Continental European and Japanese markets are characterized by a philosophy that all of a corporation's stakeholders should be considered, and the objective should be to *maximize corporate wealth*. Thus a firm should treat shareholders on a par with other corporate stakeholders, such as management, labor, the local community, suppliers, creditors, and even the government. The goal is to earn as much as possible in the long run, but to retain enough to increase the corporate wealth for the benefit of all. This model has also been labeled the *stakeholder capitalism model (SCM)*.

The SCM model does not assume that equity markets are either efficient or inefficient. It does not really matter because the firm's financial goals are not exclusively shareholder-oriented since they are constrained by the other stakeholders. In any case, the SCM model assumes that long-term "loyal" shareholders, typically controlling shareholders, should influence corporate strategy rather than the transient portfolio investor. The SCM model assumes that total risk, that is, operating and financial risk, does count. It is a specific-corporate objective to generate growing earnings and dividends over the long run with as much certainty as possible, given the firm's mission statement and goals.

5. **Corporate Governance.** Define the following terms:

- a. *Corporate governance.* Corporate governance is the control of the firm. It is a broad operation concerned with choosing the board of directors and with setting the long-run objectives of the firm. This means managing the relationship between various stakeholders in the context of determining and controlling the strategic direction and performance of the organization. Corporate governance is the process of ensuring that managers make decision in line with the stated objectives of the firm.
- b. *The market for corporate control.* The relationship among stakeholders used to determine and control the strategic direction and performance of an organization is termed *corporate governance*. The corporate governance of the organization is therefore the way in which order and process is established to ensure that decisions are made and interests are represented—for all stakeholders—properly.
- c. *Agency theory.* The field of agency theory is the study of how shareholders can motivate management to accept the prescriptions of the SWM model.<sup>1</sup> For example, liberal use of stock options should encourage management to think like shareholders. Whether these inducements succeed is open to debate. However, if management deviates too much from SWM objectives of working to maximize the returns to the shareholders, then the board of directors should replace them. In cases where the board is too weak or ingrown to take this action, the discipline of the equity markets could do it through a takeover. This discipline is made possible by the one-share-one-vote rule that exists in most Anglo-American market.
- d. *Cronyism:* Doing business with or the hiring of friends and colleagues, regardless of their qualifications or suitability.
- e. *Stakeholder capitalism.* The philosophy that all of a corporation's stakeholders should be considered and the objective should be to *maximize corporate wealth*. Thus a firm should treat shareholders on a par with other corporate stakeholders, such as management, labor, the local community, suppliers, creditors, and even the government. The goal is to earn as much as possible in the long run, but to retain enough to increase the corporate wealth for the benefit of all. This model has also been labeled the *stakeholder capitalism model*.

6. **Operational Goals.** What should be the primary operational goal of a MNE?

The MNE must be guided by operational goals suitable for various levels of the firm. Even if the firm's goal is to maximize shareholder value, the manner in which investors value the firm is not always obvious to the firm's top management. Therefore, most firms hope to receive a favorable investor response to the achievement of operational goals that can be controlled by the way in which the firm performs, and then hope that the market will reward their results. The MNE must determine the proper balance between three common operational financial objectives:

- Maximization of consolidated after-tax income.
- Minimization of the firm's effective global tax burden.
- Correct positioning of the firm's income, cash flows, and available funds as to country and currency.

These goals are frequently incompatible, in that the pursuit of one may result in a less desirable outcome in regard to another. Management must make decisions about the proper trade-offs between goals (which is why people rather than computers are employed as managers).

7. **Knowledge Assets.** "Knowledge assets" are a firm's intangible assets, the sources and uses of its intellectual talent—its competitive advantage. What are some of the most important "knowledge assets" that create shareholder value?

The definition of *corporate wealth* is much broader than just financial wealth. It may also include the intellectual capital of the firm, such as copyrights, patents, trademarks, etc. It would also include the ability to generate new ideas that can be patented or copyrighted. It also includes the firm's market and human resources. This means that a MNE that believes it must close a manufacturing facility in Stuttgart, Germany, and shift its operations to Penang, Malaysia, may not do so without considering the employment and other social impacts on the Stuttgart community. As one study put it, "[Corporate wealth] goes beyond the wealth measured by conventional financial reports to include the firm's market position as well as the knowledge and skill of its employees in technology, manufacturing processes, marketing and administration of the enterprise."

8. **Labor Unions.** In Germany and Scandinavia, among others, labor unions have representation on boards of directors or supervisory boards. How might such union representation be viewed under the shareholder wealth maximization model compared to the corporate wealth maximization model?

*Labor unions* representation required by statute is an example of governmental direction toward the corporate wealth maximization (CWM) model, in that such a requirement is intended to make the board responsive to stakeholders other than owners. Under the CWM model, such a statute would be viewed favorably, while under the SWM model such a statute would be viewed as undue interference in the right of owners to manage the assets into which they alone have invested money.

9. **Interlocking Directorates.** In an interlocking directorate, members of the board of directors of one firm also sit on the board of directors of other firms. How would interlocking directorates be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?

Interlocking directorates allow firms, via intertwined management and governance, to cooperate and/or collude. A simple answer along CWM or SWM lines is not so easy here. Many countries characterized by the CWM model, such as Germany and Japan, allow interlocking directorates so that "all stakeholders" will be represented. SWM countries, such as the United States, often prohibit interlocking directorates on the premise that they may stifle unfettered competition because decisions may be based on friendships, influence, or promises of reciprocity.

10. **Leveraged Buyouts.** A leveraged buyout is a financial strategy in which a group of investors gain voting control of a firm and then liquidate its assets in order to repay the loans used to purchase the firm's shares. How would leveraged buyouts be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?

A leveraged buyout is perceived in a country that believes in CWM as generally irresponsible. The liquidation of assets, often at market prices that do not reflect the value of the activity to workers and their communities, is not consistent with the CWM philosophy. Those believing in SWM argue that if the selling shareholders—the initial owners of the firm—are paid a price for their shares that is higher than the market as a result of the leveraged buyout, the market forces which are so important for competition and growth are allowed to work. Additionally, the selling shareholders now have more capital to freely invest in other ventures, in turn creating more jobs and attendant benefits.

11. **High Leverage.** How would a high degree of leverage (debt/assets) be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?

High leverage increases both the risk of corporate bankruptcy and the possibility of a greater rate of return for shareholders. The corporate wealth maximization model looks suspiciously at higher leverage because any benefits will flow only to shareholders, while other stakeholders (such as labor) will bear the brunt of the risk should the company go bankrupt because of the fixed financial costs of disproportionately high debt. Under the shareholder wealth maximization model, the decision on the degree of leverage resides with the owners as represented by the board, and the trade-off between risk and return is presumably based on their risk-return preferences. Under modern financial theory, the risk-return attributes of a single company are meaningful only in the context of the contribution that the company makes to a diversified portfolio.

12. **Conglomerates.** Conglomerates are firms that have diversified into unrelated fields. How would a policy of conglomeration be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?

Conglomerates created to achieve diversification are presumably looked upon more favorably in countries tied to the *corporate wealth maximization* model because the greater size of the conglomerate means the business entity in its entirety is larger; i.e., has greater wealth and is possibly less vulnerable to competition or takeover by another firm. Worker jobs are safer. An offsetting argument is that firms in CWM countries with interlocking directorates can act as if they were conglomerates, even though structurally they are not.

Under the *shareholder wealth maximization* model, conglomerates created to achieve diversification are formed only when the owners alone believe that synergies will come about because of the consolidation. Critics of conglomerates in SWM countries point out that shareholders can achieve unique diversification in their own portfolios without conglomerate diversification being “forced” upon them. Additionally, an argument is sometimes made that management skilled in one type of economic activity may be quite incapable in another type of activity, and that consequently conglomerates may perform less well overall than would a portfolio composed of the no-longer-existing separate constituent companies.

13. **Risk.** How is risk defined in the shareholder wealth maximization model compared to the corporate wealth maximization model?

*Shareholder Wealth Maximization (SWM)* firms usually consider risk as a constraint on seeking to maximize current earnings. In an operational context for managers, *risk* is usually taken to be the expected variability for earnings over a period of future years. In a more specific portfolio sense for investors (as distinct from managers), risk in SWM countries is the added systematic risk that the firm's shares bring to a diversified portfolio. *Unsystematic risk*, the risk of the individual security, can be eliminated through portfolio diversification by the investors. Thus *unsystematic risk* is not a prime concern for management unless it increases the prospect of bankruptcy. *Systematic risk*, the risk of the market in general, cannot be eliminated.

*Corporate Wealth Maximization* firms define risk in a much more qualitative sense. The term “patient capital” is sometimes used to imply that only performance over a very long-term is of concern. In addition, the much greater array of stakeholders with divergent interests implies that some sort of consensus must be reached before a decision is made that might negatively impact one of the set of stakeholders—even if other sets of stakeholders gain.

14. **Stock Options.** How would stock options granted to a firm’s management and employees be viewed by the shareholder wealth maximization model compared to the corporate wealth maximization model?

Stock options are used in shareholder wealth maximizing firms to align the interests of managers with those of shareholders, in the belief that those managers will then make decisions, which will enhance the wealth of all stockholders, including those executives. Of course, those executives are punished (financially) if the firm they manage fails to increase in market value.

Stock options to managers in corporate wealth maximizing firms are unlikely, because they seek to cause managers to act to benefit the shareholders without, necessarily, benefiting the array of other stakeholders in the firm.

15. **Shareholder Dissatisfaction.** What alternative actions can shareholders take if they are dissatisfied with their company?

Disgruntled shareholders may:

- a. *Remain quietly disgruntled.* This puts no pressure on management to change its ways under both the shareholder wealth maximization model and the corporate wealth maximization model.
- b. *Sell their shares.* Under the SWM model, this action (if undertaken by a significant number of shareholders) drives down share prices, making the firm an easier candidate for takeover and the probable loss of jobs among the former managers. Under the CWM model, management can more easily ignore any drop in share prices.
- c. *Change management.* Under the one-share, one-vote procedures of the SWM model, a concerted group of shareholders can vote out existing board members if they fail to change management practices. This usually takes the form of the board firing the firm’s president or chief operating officer. Cumulative voting, which is a common attribute of SWM firms, facilitates the placing of minority stockholder representation on the board. If, under the CWM model, different groups of shareholders have voting power greater than their proportionate ownership of the company, ousting of directors and managers is more difficult.
- d. *Initiate a takeover.* Under the SWM model it is possible to accumulate sufficient shares to take control of a company. This is usually done by a firm seeking to acquire the target firm making a tender offer for a sufficient number of shares to acquire a majority position on the board of directors. Under the CWM model, acquisition of sufficient shares to bring about a takeover is much more difficult, in part because non-shareholder stakeholder wishes are considered in any board action. (One can argue as to whether the long-run interests of non-shareholding stakeholders are served by near-term avoidance of unsettling actions.) Moreover, many firms have disproportionate voting rights because of multiple classes of stock, thus allowing entrenched management to remain.

16. **Dual Classes of Common Stock.** In many countries it is common for a firm to have two or more classes of common stock with differential voting rights. In the United States the norm is for a firm to have one class of common stock with one-share-one-vote. What are the advantages and disadvantages of each system?

A variety of arguments exist as to why Europeans allow this differential in voting rights. In some countries it is believed that “ordinary” individual shareholders are not qualified to influence business decisions. The average share-owning individual investor is presumed to be neither business-oriented nor knowledgeable about the business and prospects for the firm in which shares are owned.

Hence they are not sufficiently informed to be trusted with influence of the selection of directors or other important corporate issues. Dual classes of stock allow one class (the “informed professional”) to control the company while the second class (the “uninformed amateur”) to provide capital and reap ownership rewards but not have a chance to “mess up the company” by having power over decisions.

A second reason for dual classes of stock is that takeover bids by other companies are made more difficult because the acquiring company would have to purchase the class of stock that has voting power, which class is usually held or controlled by a foundation, a family, or existing management. Hence the job tenure of existing management and ownership is made more secure, even if they do not perform well and the value of shares in the market drops.

17. **Emerging Markets and Corporate Governance Failures.** It has been claimed that failures in corporate governance have hampered the growth and profitability of some prominent firms located in emerging markets. What are some typical causes of these failures in corporate governance?

Causes include lack of transparency, poor auditing standards, cronyism, insider boards of directors (especially among family-owned and operated firms), and weak judicial systems.

18. **Emerging Markets and Corporate Governance Improvements.** In recent years emerging market MNEs have improved their corporate governance policies and become more shareholder-friendly. What do you think is driving this phenomenon?

It is driven by the need to access global capital markets. The depth and breadth of capital markets is critical to growth. Country markets which have had relatively slow growth or have industrialized rapidly utilizing neighboring capital markets may not form large public equity market systems. Without significant public trading of ownership shares, high concentrations of ownership are preserved and few disciplined processes of governance developed.

19. **Developed Markets and Corporate Governance Failures.** What have been the main causes of recent corporate governance failures in the United States and Europe?

Many would argue the root cause is greed. In numerous cases, prestigious auditing firms, such as Arthur Andersen, missed the violations or minimized them possibly because of lucrative consulting relationships or other conflicts of interest. Moreover, security analysts and banks urged investors to buy the shares and debt issues of these and other firms that they knew to be highly risky or even close to bankruptcy. Even more egregious, most of the top executives that were responsible for the mismanagement that destroyed their firms, walked away (initially) with huge gains on shares sold before the downfall, and even overly generous severance payments.

20. **Family Ownership.** What are the key differences in the goals and motivations of family ownership of the business as opposed to the widely held publicly trade business?

A privately held firm has a much simpler shareholder return objective function: maximize current and sustainable income. The privately held firm does not have a share price (it does have a value, but this is not a definitive market-determined value in the way in which we believe markets work). It therefore simply focuses on generating current income, dividend income, to generate the returns to its ownership. If the privately held ownership is a family, the family may also place a great emphasis on the ability to sustain those earnings over time while maintaining a slower rate of growth, which can be managed by the family itself. It is therefore critical that ownership and ownership’s specific financial interests be understood from the very start if we are to understand the strategic and financial goals and objectives of management.

21. **Value of Good Governance.** Do markets appear to be willing to pay for good governance?

A recent McKinsey study surveyed over 200 institutional investors as to the value they placed on good governance. The survey results presented in Exhibit 2.3 quantify good governance in the premium that institutional investors would be willing to pay for companies with good governance within specific country markets. Although this is not exactly equivalent to saying who has “good” or “bad” corporate governance globally, it does provide some insight as to which countries institutional investors see good governance as scarce. It is again important to note that most of the emerging market nations have relatively few publicly-traded companies even today.

22. **Corporate Governance Reform.** What are the primary principles behind corporate governance reform today? Are these culturally specific in your opinion?

Within the United States and United Kingdom, the main corporate governance problem is the one treated by *agency theory*: with widespread share ownership, how can a firm align management’s interest with that of the shareholders? Since individual shareholders do not have the resources or the power to monitor management, the U. S. and U. K. markets rely on regulators to assist in the agency theory monitoring task.

Outside the United States and United Kingdom, large controlling shareholders are in the majority (including Canada). They are able to monitor management in some ways better than regulators. However, controlling shareholders pose a different agency problem. How can minority shareholders be protected against the controlling shareholders?

In recent years reform in the United States and Canada has been largely regulatory. Reform elsewhere has been largely an adoption of principles rather than stricter legal regulations. The principles approach is softer, less costly, and less likely to conflict with other existing regulations.